ROUTING AND RECORD SHEET

SUBJECT: (Optional)

STAT GEHA Investment Study

FROM: | EXTENSION | NO.

STAT [redacted] | [redacted] | DATE 14 November 1973

TO: (Officer designation, room number, and building)	DATE RECEIVED	DATE FORWARDED	OFFICER'S INITIALS	COMMENTS (Number each comment to show from whom to whom. Draw a line across column after each comment.)
STAT [redacted]				Here is the study of GEHA investment policies and investments per our earlier discussions. I'd like to discuss the recommendations with you--at your earliest convenience--because some of them may relate to the overall investment study nearing completion. STAT [redacted] have reviewed the attached paper. Clay
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 73-1549

13 November 1973

MEMORANDUM FOR: Chairman, GEHA Investment Committee

SUBJECT: Review of GEHA Investments

Purpose

1. Pursuant to our recent discussions, I undertook this review of some GEHA investing policies and practices and of the portfolio. While the experience of the portfolio has been good, there are some areas where improvements possibly can be achieved; nine recommendations are made.

Board's Investing Authority

2. Article VII, Section 1 of the By-laws gives the Board of Directors wide discretion in making investments, it being provided that they "... shall have authority to invest and expend funds of the Association as they deem best ...." Thus, the By-laws indicate the Board may invest in a broad range of security types, as it chooses. To date, only four types of securities--common stock, corporate and Federal agency bonds, and U.S. Treasury bills have been purchased.

3. Other types of securities that could be purchased are:

U.S. Treasury Notes
U.S. Treasury Bonds
Commercial Paper (issued by major corporations)
Certificates of Deposits (issued by major banks)
Bankers Acceptances (issued by major banks)

The choice(s) at any time will be governed by GEHA investment objectives, and depend on such factors as relative interest rates, liquidity and maturity requirements, and the mix of risks wanted. Risk in any of these additional types is or can be less than that the Board has accepted in the past.

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Portfolio Management

4. Your investment committee may want to review how best to operate. Some basic considerations:

a. investment objectives
b. investing strategy
c. policy guidelines
d. decision points
e. regular reporting

These five are suggested because, with improvements in each possible, the overall portfolio management might be improved. Each is discussed below.

5. Investment Objectives. Maximized rate of return is the goal--taking due account of liquidity and risk factors. (See brief general discussions in Tab A.) For fixed income securities the yields achieved should exceed those possible on "riskless" investments (i.e., U.S. Treasury or some Federal agency issues). For common stocks the returns should exceed some standard index.

Recommendation #1. Aim for a yield on fixed income securities that exceeds by at least 1% the "yield" obtainable on the Salomon Brothers' Index[1] for 10 year maturity.

Recommendation #2. Aim for a return on common stocks that exceeds the S&P 500 by 20% in up markets, and that does at least as well as the S&P 500 in down markets.

Implicit in both recommendations is establishment of a performance measurement system--a system that should and can be kept simple but sufficient in view of the relatively small size of the GEHA portfolio. (Note that recommendation #2 is related to recommendation #9.)

6. Investing Strategy. Other than the general factors covered in Tab A, the main efforts in achieving high returns involve two considerations. First, correct predictions of interest rate movements are necessary to allow shortening of maturities in anticipation of a rise in interest rates to minimize depreciation of principal, and vice versa.

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[1] This composite index covers four federal agency securities, all largely backed by the full faith and credit of the U.S. Government. (Federal National Mortgage Assoc.; Federal Land Bank; Federal Intermediate Credit Banks; Federal Home Loan Bank Board.) Index is published monthly in Salomon Bros. Historical Record of Yields and Yield Spreads.

Of course rates are difficult to predict but often reasonable judgments can be made. Second, correct appraisal of yield spread disparities allow, now and then, timely swaps for net gains in holdings. Note, for example, in Tab B the standard form used by T. Rowe Price to summarize bond swaps or trades. Consistent efforts along these lines, coordinated with GEHA's cash flow needs, should improve overall portfolio yields. In particular an expanded mix of security holdings, as discussed in para. 3 above, would give greater flexibility in managing for better yields and an improved maturity schedule.

Recommendation #3. Arrange for a person to be responsible for appraising interest rate trends and projections, from appropriate sources, and report same to the Investment Committee regularly.

Recommendation #4. Arrange for a person to be responsible for developing a working relationship with Phil Shepard and others for the purpose of spotting, from time to time, beneficial swap opportunities.

In each of these cases, the responsible person(s) would report to the Investment Committee for appropriate actions. Timely action by the Committee will usually be paramount, especially for swaps where minutes can count, and should be arranged for.

7. Investing Strategy (cont'd). Since inception the portfolio has grown to over $2 million, and no large withdrawal demands are likely in the next two or three years. There are three sources or possible sources of demand. First, the current agreement with UBLIC requires payment of claims of up to $66,000 per year if not coverable by excess premiums. Second, and more important, the possible payment of claims from free life insurance awarded eligible retirees will ultimately increase. The claims must be paid from the portfolio if they exceed refund premiums, as they will eventually. The insurance company's latest estimate is that "ultimately" $400,000 per year will have to be withdrawn from the portfolio to meet such claims. A third and regular source of payout is the $33,000 paid yearly to reimburse the Agency for three personnel assigned to work on GEHA. Thus, while liquidity and the maturity schedule are not immediate problems, they should be looked at soon, as portfolio strategy is being developed.

Recommendation #5. Have a study done with/by Mutual of Omaha projecting as well as possible the cash flow associated with the retirement benefits.

This study is necessary in order to structure a better maturity schedule. Otherwise, the Board may eventually need funds and be forced to liquidate unmatured holdings at unfavorable times in the market.

8. Policy Guidelines. The Board and the Investment Committee could promulgate more specific policy guidelines for investing decisions. For example, present policies limit investment in common stock (at cost) to no more than 10% of the amount in the UBLIC and Contract Life trust liability accounts in the portfolio, and prescribe that fixed income securities must be graded BB or better. More explicit policies related to these and other areas would aid the Committee decision-making and allow delegation of, for example, some transacting authority to lower levels. Tab C gives some policy issues for your consideration.

Recommendation #6. Establish a set of policy guidelines to aid investing strategy formulation and especially to allow more routine decisions to be made quickly by designated personnel without polling or convening the Board or Investment Committee.

Such guidelines and possible delegation would not weaken, but rather would strengthen and clarify, the mandates of the Board.

9. Decision Points. At present all investment decisions are made by the Investment Committee but probably some of the more routine decision-making could be delegated. For example, as small amounts of moneys accumulate or as securities mature, the President [redacted] or STAT
STAT Chief, Insurance Branch [redacted] could be authorized to invest such funds in a daily compounded savings account, U.S. Treasury bills, certain commercial paper, certain Bankers Acceptances, or the like until the Investment Committee wanted to take other action. Such short term investments also could be routinely made as part of a strategy of waiting for long term interest rates to move higher.

Recommendation #7. Authorize establishment of a daily compounded bank account and designate certain classes of short term securities that the President or Chief, Insurance Branch may invest in while awaiting investment action by the Investment Committee.

Such authorization will assure that funds are never idle but always invested and earning.

10. Regular Reporting. The Board and the Investment Committee need regular reporting upon which to base actions. These could be simple in nature: a formatted report to show essential data on current holdings (see Tabs D, E, F, and I); a maturity schedule (see Tab H) and cash flow needs; a form recording advantages and disadvantages of swaps made to upgrade the portfolio (see Tab B); and, separate from the portfolio, reports on the outlook for interest rates synthesized from appropriate sources.

> Recommendation #8. Establish quarterly reporting for the portfolio holdings, adopt the swap format shown for upgrading transactions, and arrange for frequent reports as needed on the outlook for interest rates.

Such reporting will enhance the decision-making capability of the Board and the Investment Committee.

Present Portfolio Holdings

11. Tab D summarizes the security holdings in the portfolio--as of 12 June 1973 and 7 September 1973 for fixed income securities and common stocks, respectively. The same securities, except the Treasuries which have matured, are still held as of this writing although valuations differ. (Proceeds from the Treasuries plus additional funds, all totalling about $300,000 were reinvested in 29-day Bankers Trust commercial paper, maturing 29 November 1973 and yielding 8.65%.)

12. Corporate bonds (Tab E) are the largest holdings, comprising about 83% of the total. (Of this amount most are in S&P single A bonds (Tab F)[2].) One caveat for bond holdings is that their ratings must be frequently watched--any downgrading would result in a lowering of the price and thus a capital loss if liquidated before maturity. For the bond holdings the weighted average yield-to-maturity from purchase date is a respectable 7.9%[3] (Tab G shows the method of computing yields to maturity.)

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[2]Tab F also defines the S&P grading system for bonds.

[3]Computed yield-to-maturity always just approximates the realized yield because final results depend on rates at which income is reinvested.

13. The present maturity schedule (Tab H) is about evenly spread up through 12 years, but with some bonds maturing at 16 and 25 years. This spread is probably about appropriate but should be reviewed and, if necessary, adjusted in accordance with the cash flow needs discussed under recommendation #5 above.

14. Some specific comments on the present fixed income holdings can be made relating maturity, grade, and yield-to-maturity (referring to Tab E):

a. Talley Indus. (BB), YTM 7.9% -- This yield is too low considering 24 years to hold and relatively low grade. Probably should try to switch into higher grade at higher yield, even if at shorter maturity. Bond is now callable and likely will be called if rates fall much below the 8-1/8% coupon.

b. Low coupon holdings (four) -- If we expect years of sustained high interest rates, which seems likely unless inflation is controlled more, then it would be better to hold high coupon securities so the greater income could be reinvested at high rates; this would improve overall yield. Higher income may also be necessary later depending on cash flow needs.

c. Bankers Trust commercial paper ($300,000 maturing 29 November 1973) -- If long term interest rates have moved a little higher by maturity date, as expected, then the funds probably should be invested long term.

d. Each holding -- Possible swaps that either increase yield at the same grade or improve grade at the same yield should be sought. Quick approval decisions (within an hour or so) will normally be required.

Action on these items over time should upgrade the fixed income portfolio in terms of yield and quality, and follow naturally from the previous recommendations.

15. Equity holdings are shown in Tab I.[4] The rate of return (yield plus capital gains) averages about 9% or so. This return is not much more than that earned on fixed income securities, especially considering the

4Tab I also explains the S&P ranking system for common stocks.

greater risks involved. My general view is that common stocks require more care in selection and more vigilant attention than fixed income securities because of the rapid changes in a company's fortunes that can occur. Nine different issues in six different industry groups is probably more than adequately can be followed for a small $253,000 portfolio--unless there is a Board member or other person with time and inclination to devote to the stock market and the GEHA holdings. Further, the stock market may not again experience the steady rise of the post-war era--certainly the last four years have been difficult for the stock market.

> Recommendation #9. Eliminate all or reduce the number of different common stocks in the portfolio at the next good rise in the stock market, or have a qualified person willing to devote necessary time to oversee the holdings.

More consistent and probably as good returns can be achieved by concentrating exclusively on investing in fixed income instruments. If common stocks are to continue being a part of the portfolio, then they should be a few quality issues with favorable long term prospects. A variation of this strategy would be purchase of such issues when they (and the market) seem unduly depressed and sell them when higher P/E multiples are achieved.

16. I realize that some of these recommendations, especially numbers 3 and 4, require manpower perhaps not presently available to GEHA. However, this problem can be worked around with some trade offs here and there. Also, depending on Mr. Colby's reactions to recommendations in an investment study now being prepared, the Agency may soon have professional portfolio management capability that could be of some use to GEHA.

STAT

Planning Staff, OPPB

Att: a/s

Tab A

Four Basic Factors in Portfolio Management

Safety of Principal -- Funds should be invested in securities where risk of default is at an acceptable level. Present Board policy is that only bonds with an S&P quality rating of BB or better may be purchased.

Liquidity -- The maturity schedule should be such as to serve liquidity needs without loss of capital in case premature sale is necessary. GEHA now and for the next several years should have no large cash needs so that liquidity is not a major consideration. However, the mix of short and longer term securities should be reviewed (but more discussion on this later).

Quality -- Refers to fluctuation in market price of a security with supply and demand. It is desirable for the price not to fluctuate to too low a level at any time in case an early, unexpected liquidation is required. Liquidity needs of GEHA, while not great for the next few years, could be a significant factor later -- thus quality in this respect for long term bonds should be considered. Usually, the longer the maturity the greater the fluctuation in price.

Yield -- After adequate safety, liquidity, and quality are considered, the highest yield is sought. However, because higher yields are achieved in lower grade securities (of given maturity) the Board may, as a matter of policy, want to establish the proportions of various S&P ratings to be maintained in the portfolio. This policy will prevent possible excessive accumulation of lower grade issues.

CORPORATE BOND/TRADE ANALYSIS

Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Yield to: Avg.Life	Yield to: Call	Ratings	Call Data	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL												
$1,000,000	U.S. Government	3 1/2%	11/15/98	77	5.07%			Aaa	---		None	
					(1)							
BUY												
$1,000,000	A. T. & T.	5 1/2%	1/1/97	77 1/2	7.45%			Aaa	---		None	

Advantages of Trade

1. Pick up 238 basis pts. yield to maturity.
2. Pay up recovered in 3 months.
3. Increase income $20,000 per year.

Disadvantages

1. Credit
2. Market
3. Pay up

Comparison Statement

Proceeds of Sale	$	770,000
Cost of Purchase	$	775,000
Take/Put up	$(3)	5,000
New Coupon	$	55,000
Old Coupon	$	35,000
Annual Increase	$(2)	20,000

Date: 12/18/71

Dealer: F.S.S. v M.L.

Settlement: Reg.

TAB B(2

CORPORATE BOND/TRADE ANALYSIS

Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Yield to: Avg.Life	Yield to: Call	Ratings	Call Data	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL												
$2,000,000	U.S. Government	6 1/8%	11/15/86	98	6.34%							
			(2)		(1)							
BUY												
$2,000,000	U.S. Government	6 3/8%	8/15/84	98	6.62%							

Due to hump in yield curve

Advantages of Trade	Disadvantages
1. Increase yield to maturity by 28 basis points.	
2. Shorten maturity.	
3. Income increase of $5,000 per year.	

Comparison Statement

Proceeds of Sale	$ S A
Cost of Purchase	$ M
Take/Put up	$ E
New Coupon	$ 127,500
Old Coupon	$ 122,500
Annual Increase	$(3) 5,000

Date:

Dealer: S.B.

Settlement: Reg.

STAT

 Intermarket spread swap

CORPORATE BOND/TRADE ANALYSIS

TAB B (3)

Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Yield to: Avg.Life	Yield to: Call	Ratings	Call Data	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL												
$1,000,000	U.S. Government	6 1/4%	8/15/79	98.948	6.44%							
					(1)							
BUY												
$1,000,000	FNMA	6.55%	12/10/79	98.12	6.84%							

well

Advantages of Trade

1. Increase yield to maturity by 40 basis points.
2. Income increase $3,000.
3. Take out $8,280.
4. Spread - wide - downgrade - value

Disadvantages

1. Credit
2. Market

Comparison Statement

Proceeds of Sale	$ 989,480.
Cost of Purchase	$ 981,200
Take/Put up	$(3) 8,280
New Coupon	$ 65,500
Old Coupon	$ 62,500
Annual Increase	$(2) 3,000

Date:

Dealer: S.B.

Settlement:

#0210

CORPORATE BOND/TRADE ANALYSIS

TAB B (

	Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Avg.Life	Call	Ratings	Call Date	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL	$200,000	Pacific Telephone	9 1/8%	12/1/04	111	8.16%		6.09%	Aaa	12/1/74 @ 104.76			
								1		2			
BUY	$200,000.	Public Serv. E&G	9 1/8%	6/1/00	112	8.04%		7.12%	Aa	3/1/75 @ 108.62			
4										3			

Advantages of Trade

1. Increase yield to first refunding date by 103 basis points.
2. Increase call price by 3.86 points.
3. Extend refunding date by 3 months.
4. Consolidate portfolio.

Disadvantages

Comparison Statement

Proceeds of Sale	$
Cost of Purchase	$
Take/Put up	$
New Coupon	$
Old Coupon	$
Annual Increase	$

Date: 5/30/72

Dealer: W. W.

Settlement: Regular

CORPORATE BOND/TRADE [illegible]

TAB B(5)

Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Yield to: Avg. Life	Yield to: Call	Ratings	Call Data	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL												
$1,000,000	Chesapeake & Pot.	6 3/4%	2/1/79	100-1/4%	6.70%			Aaa			None	
					↓ (1) ↑							
BUY												
$1,000,000	Fed. Land Banks (2)	6.85%	4/23/79	100	6.85%			Aaa			None	

One of strongest of Fed. Agencies

Due to new issue discrepancies (last 2 hrs or so .. all fast)

Advantages of Trade

1. Increase in yield by 15 basis points.
2. Improve market and quality.
3. Take out $2,500.
4. Increase in income.

Disadvantages

Comparison Statement

Proceeds of Sale	$
Cost of Purchase	$
Take/~~XXXXX~~	$(3) 2,500
New Coupon	$ 68,500
Old Coupon	$ 67,500
Annual Increase	$(4) 1,000

Date: 8/30/72

Dealer: W.W.

Settlement: Reg.

STAT

CORPORATE BOND/TRADE ANALYSIS

Par Value	Issue	Coupon	Maturity	Price	Yield to: Maturity	Yield to: Avg.Life	Yield to: Call	Ratings	Call Data	Amount Outsdg.	Annual Sinking Fund	Avg. Life
SELL												
$5,000,000	FNMA	6.80%	9/1/75	100	6.80%							
BUY												
$5,000,000	Fed. Ld. Bks.	7.15%	5/1/75	100	7.15%							

(Dealer was short FNMA — was willing to pay up)

Advantages of Trade

1. Pick up 35 basis points yield to maturity.
2. Upgrade.
3. $35,000 over two years.
income

Disadvantages

Comparison Statement

Proceeds of Sale	$ 5,000,000.00
Cost of Purchase	$ 5,000,000.00
~~XXXXXXXXX~~	$
New Coupon	$ 357,500.00
Old Coupon	$ 340,000.00
Annual Increase	$ 17,500.00

Date:

Dealer:

Settlement:

TAB C

SOME POLICY ISSUES

1. Common stocks. Should investment in common stocks be continued, or should the present holdings be phased out to allow focusing of limited manpower on fixed income securities?

2. Common stocks. What criteria will govern selection (and disposal) of common stock?

3. Mix of risks. What proportion of risks (S&P ratings AAA, AA, A, BBB, BB) in fixed income securities shall the portfolio have?

4. Swaps or Buy-and-hold. Should the buy-and-hold-to-maturity policy be continued or should profitable swap opportunities be sought and taken?

5. Investment Decisions. Should guidelines be set to allow delegation of authority for purchase of certain securities? If so, to whom should the authority be delegated, under what circumstances, and which short-term securities will be on the approved list?

TAB D

Summary of Holdings at Cost
(as of 12 June 1973--fixed income)
(as of 7 Sept 1973--equities)

Fixed Income Securities		
Corporates	$1,816,010	82.9%
Federal Agency	10,000	0.4
U.S. Treasury	183,464	8.3
Common Stock	188,816	8.6
	$2,189,290	100.0%

TAB E

FIXED INCOME SECURITIES
(as of 12 June 73)

Name	Purchase Date	Cost	Value at Maturity	Coupon Rate	frm Purchase Yield to Maturity	Maturity Date	Call Date	S&P Rating
AVCO Financial Services (Formerly Seaboard Finance)	12/70	$ 190,741.43	$ 185,000	9.25	8.9	4/1/90	4/1/80	A
Commercial Credit	2/71	149,525.00	200,000	4.50	7.4	8/1/85	8/1/71	A
FNMA	3/70	10,000.00	10,000	8	8.0	4/1/75	--	AAA
Freuhauf	9/71	102,583.34	100,000	7.50	7.4	1/1/78	1/1/77	A
Freuhauf	3/71	202,355.00	200,000	7.50	7.4	1/1/78	1/1/77	A
International Harvester	2/71	159,830.54	200,000	4.75	7.6	8/1/81	8/1/70	A
La Clede Gas	2/71	154,050.00	200,000	4.50	7.6	2/1/83	Callable	A
Lone Star Gas	2/71	162,365.96	200,000	4.625	7.2	4/15/82	Callable	A
May Dep't. Stores Credit Company	9/70	146,164.47	145,000	8.875	8.72	9/15/76	3/15/76	A
McCulloch Properties	3/71	200,369.44	200,000	9.50	9.4	3/1/76	Not Call.	A
Santa Fe Pipe Line	1/71	40,165.28	40,000	8.75	8.7	12/1/80	Not Call.	BBB
Talley Industries	12/72	304,859.37	300,000	8.125	7.96	12/1/97	Callable	BB
Treasury Bills	4/73	183,464.50	190,000	6.814*	7.25	10/4/73	--	AAA
	TOTAL	$2,000,474.33	$2,170,000		Avg 7.90			

*Discount rate

TAB F (1)

Proportions of Different S&P Graded
Fixed Income Securities in the Portfolio
(based on cost; as of 12 June 1973)

AAA	9.7%	(includes 9.2% (includes 9.2% cash as of 24 Oct 1973)
AA	0	
A	73.1	
BBB	2.0	
BB	15.2	
	100.0%	

S & P Ratings

Bonds and Preferred Stock

AAA	Prime
AA	High Grade
A	Sound
BBB	Medium Grade
BB	Lower Grade
B	Speculative
C	Sub-Marginal

Common Stock

A+	Highest
A	High
A-	Above Average
B+	Average
B	Below Average
B-	Low
C	Lowest

*Ratings reflect: for Bonds - ability to service debt
Preferreds - relative security of dividends
Common - stability and growth of earnings and dividends

TAB ___

Computing Yield to Maturity

$$P_s = \frac{A}{r} + \frac{1}{(1 + r)^n} \left(100 - \frac{A}{r}\right)$$

$$= \frac{A}{r} + \frac{1}{e^{n\ln(1 + r)}} \left(100 - \frac{A}{r}\right)$$

Where

A = \$ received semiannually

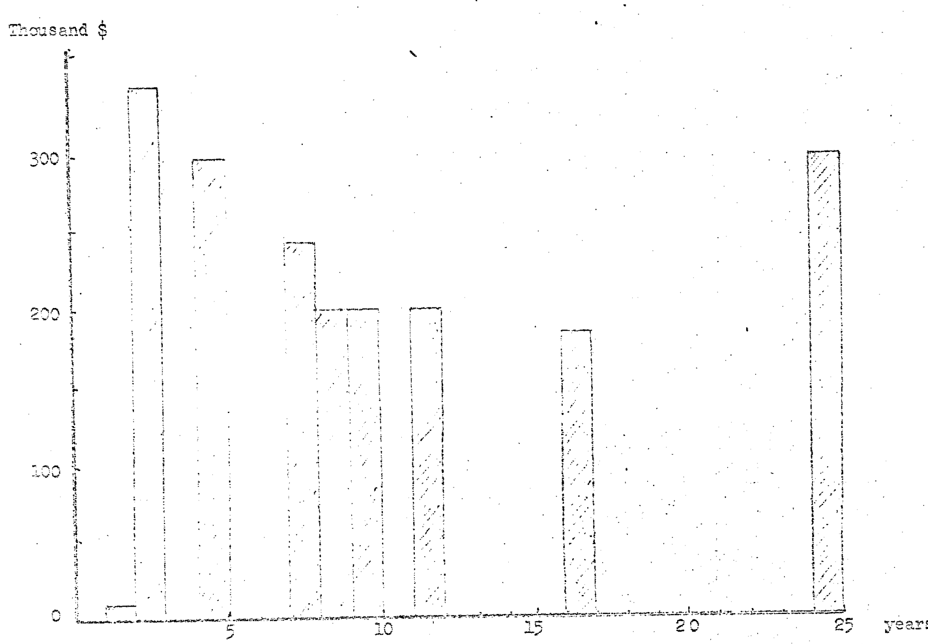
n = number of semiannual periods until maturity

P_s = \$ market value (i.e., cost)

r = yield to maturity (semiannual rate)

TAB H

Approximate Years to Maturity for Fixed Income Securities
(from 10 Oct 1973)



COMMON STOCK HOLDINGS
(as of 7 Sept. 1973)

Name (Industry)	Number of Shares	Purchase Date(s)	Cost	Value as of Close 7 Sept '73	Annualized rate of gain	Current Annual Dividend/sh	Current Yield (based on cost)	S&P Ranking
Allied Chemical (Chem)	370	12/13/72	$ 11,590	$ 13,089	17.6	$1.32	4.2%	B+
Abbott Laboratories (Drug)	300	8/31/71	19,239	18,750	(1.3)	1.20	1.9	A
Diversified Mortgage Investments (Reit)	1,000	8/31/71	28,848	23,250	(10.2)	2.84	9.8	--
Dow Chemical (Chem)	800	3/7/69; 10/6/72	24,208	46,400	15.6	1.00	3.3	A
Eastman Kodak (Photo)	100	9/30/69	7,972	13,463	14.0	1.28	1.6	A+
B. F. Goodrich (Tire & Rubber)	500	12/13/72	15,565	10,625	(39.9)	1.00	3.2	B+
Government Employees Life Insurance (Insur.)	1,030	3/7/69; 9/30/69 12/21/70	27,125	43,003	10.8	.80	3.0	--
Warner Lambert (Drug)	1,064	9/22/70; 1/8/71	27,673	45,486	18.0	.72	2.8	A
Western Casualty Surety (Insurance)	1,600	5/6/71	26,597	39,600	18.9	.56	3.4	--
		TOTAL	$188,816	$253,666	Wt. Avg 5.6		Wt. Avg. 4.0	

TAB I (2)

EARNINGS AND DIVIDEND RANKINGS FOR STOCKS

The relative "quality" of common stocks cannot be measured, as can that of bonds, which depends upon the degree of protection for interest and principal. However, there are differences in the nature of stocks and some of them are well worth measuring and comparing.

Standard & Poor's Rankings are designed to indicate by the use of symbols the relative stability and growth of earnings and the relative stability and growth of dividends. These measures of past records have a considerable bearing on relative quality, but do not pretend to reflect an examination of all other factors, tangible and intangible, that also bear on a stock's quality. *Under no circumstances should these rankings be regarded as a recommendation to buy or sell a security.*

The Common Stock Formula

Standard & Poor's point of departure is a scoring system based upon earnings and dividend records. The first step is to examine the earnings record of the past eight years. In measuring earnings stability, a basic score is given for each year in which net per share equals or exceeds that of the preceding year. For any year in which earnings declined, the score is reduced by the percentage of that decline. The average of these eight annual scores, weighted for frequency of earnings declines, becomes our first "basic earnings index."

This stability index is then multiplied by a growth index, based on the square root of the percentage by which earnings increased between the base years period and the most recent three years. To prevent growth in extreme cases from dominating the rating, the growth factor is "topped" at 150%.

Scoring for dividend stability and growth is similar, with the principal exception that a longer period is used and results are weighted for recency. A dividend reduction fifteen years ago is obviously a less serious current investment consideration than one that was voted recently. A further weighting is applied for frequency of dividend reductions, because an erratic dividend policy is a matter affecting investment standing. The result is multiplied by a growth factor similar to that for earnings.

When this is completed, the two factors—earnings and dividends—are combined into a single numerical ranking. All the common stocks so graded are then grouped into seven classes. To these we have assigned an easy-to-understand code, as follows:

A+ Highest	B+ Average	C Lowest
A High	B Below Average	
A− Above Average	B− Low	

These mathematically determined positions are modified in some instances by special considerations. Non-recurring costs, windfall profits, etc., must sometimes be allowed for. These are certain other exceptions. In the oil industry, for example, so-called "cash flow" is used rather than final net profit in order to avoid the distortions that might be caused by differences in accounting practices.

Since earnings and dividends of regulated public utilities characteristically are more stable than those of most non-regulated industries, numerous other factors must be considered. Among these are capital structure, amount of depreciation reserves, condition of properties, growth potentialities for individual service areas, the regulatory environment, and the rate of return.

These scorings are not to be confused with bond quality ratings, which are arrived at by a necessarily altogether different approach. Additionally, they must not be used as a substitute for market recommendations; a high graded stock may at times be so over-priced as to justify its sale, while a low score stock may be attractively priced for purchase. Rankings based upon earnings and dividend record are no substitute for analysis. Nor are they quality ratings in the complete sense of the term. They cannot take into account potential effects of management changes, internal company policies not yet fully reflected in the earnings and dividend record, public relations standing, recent competitive shifts, and a host of other factors that may be relevant to investment status.

N.R. signifies No Ranking possible, because of insufficient data, non-recurring factors, or some other reason.

*Preceding ranking denotes railroad guaranteed stock quality rating based on S&P bond rating scale.

Preferred Stock Ratings

Quality ratings on preferred stock are expressed by symbols like these used in rating bonds. They are independent of Standard & Poor's bond ratings, however, in the sense that they are not necessarily graduated downward from the ranking accorded the issuing company's debt. They represent a considered judgement of the relative security of dividends, and—what is thereby implied—the prospective yield stability of the stock. These ratings are as follows:

AAA Prime	BBB Medium Grade	C Sub-Marginal
AA High Grade	BB Lower Grade	
A Sound	B Speculative	